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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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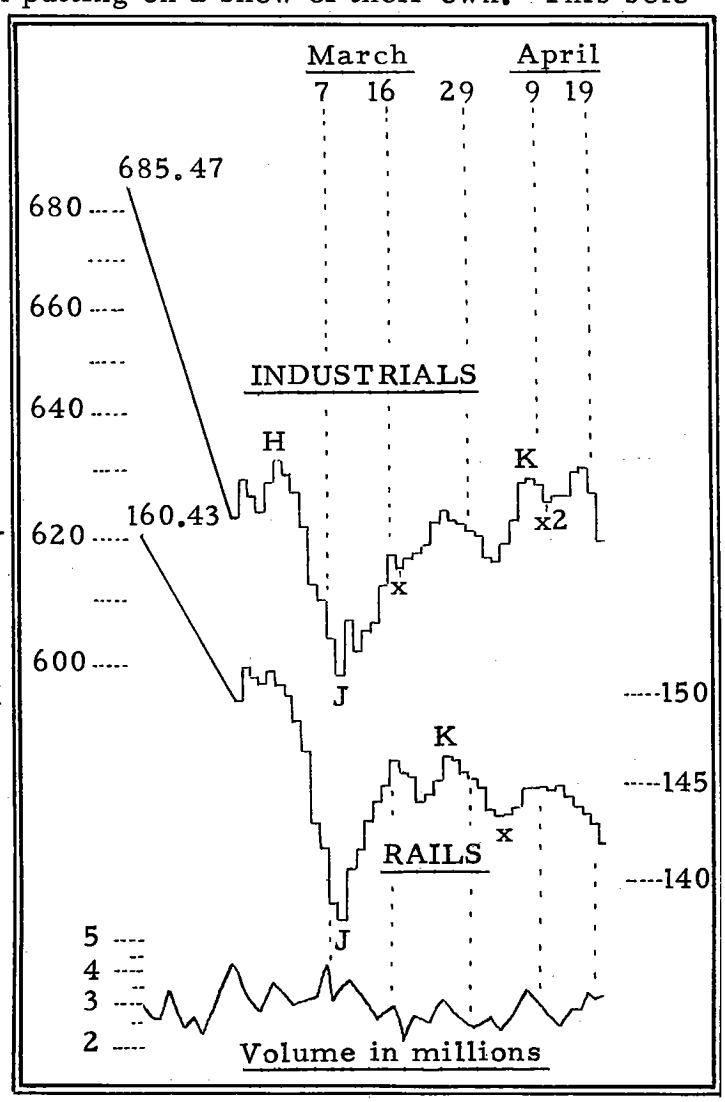
PRICE MOVEMENTS. Although the pattern of the Averages through mid-March and early April suggested that a "line" was forming, the more recent action of the Industrials makes such a classification doubtful. By last week it was clear that the two Averages were presenting a classic picture of divergence, with Industrials in a definite series of upward zig-zags and Rails unwilling to confirm the move.

On April 14 Industrials rallied above their K point, but Rails stubbornly refused even to move in direction. Such divergence is usually a danger signal. Between April 6 and 12, in fact, while Industrials were rallying, the Rails fluctuated within the amazingly narrow area of 26¢. When this tight little Rail structure was broken downside (April 14), the carriers promptly violated their previous decline low at point x, thereby making their closest approach to the bear market low at J (138.18).

Industrials, over the last few weeks, have been putting on a show of their own. This solo performance should not have deceived Dow Theorists, however, since the Theory plainly states that the indications of a single Average unconfirmed by the other are meaningless for prediction purposes and are, more often than not, deceptive. When Industrials bettered their K point the ensuing rally took them just 23¢ short of the February high at H (632.00). But on April 19 the persistent Rail weakness finally prevailed; on that day Rails violated their previous decline low at x and Industrials broke sharply in sympathy. April 20 was marked by the worst drop in seven weeks as Industrials lost 7.69 points, Rails .93. This move took Industrials below their minor lows at x2. If Industrials break point x (615.09) the whole price structure will appear decidedly bearish, and a testing of the J lows will be in order.



The rally from the March 8 bear market lows (at J) has lasted six weeks. During that period the two Averages retraced 37% of all losses since January 5. Both in duration and extent the retracement since March 8 qualifies as a secondary reaction in a bear market. This means that any future movement which takes both Averages below the J points (Industrials 599.10, Rails 138.18) must be classified as part of the third leg of the bear market.

The first leg began on July 8, 1959 and extended into September-November, 1959. The second leg began on January 5, 1960, and carried through to March 8. A forthcoming joint violation of the J points would mean that the third leg began for Industrials on April 18th at 630.77, for Rails on March 24 at 146.56.

"Investors" who made recent purchases have bought into a bear market rally; I know of no better way of reducing one's bank balance. The primary and secondary trends are down. The sensitive minor trend turned down when Industrials broke their preceding minor decline lows at x2 on chart.

At the turn of the year the owner of a highly respected market service told me, "Be careful when you turn bearish. As soon as a service turns bearish most readers demand that all stocks literally 'melt' before their eyes." There is a great deal of wisdom in those words, the more so since neither this writer nor Dow's Theory can make any claim to being able to forecast the rapidity, duration or extent of a primary movement. During a bull market investors do not mind waiting months or even years before their stocks rise with the trend. Temporary reversals are usually greeted philosophically. But in a bear market (particularly in the early stages) an entirely different psychology prevails. If a stock which was sold rallies three points the seller becomes gloomy and bemoans the fact that he could not "pocket" the last dollar. Even investors who formerly made pious statements about "selling before the top" seem to be under psychological pressure during each rally in a bear market.

"Dow's Theory of interpreting the forecasting implications of the movements of the Dow-Jones Industrials and Railroad stock averages leaves much to be desired;" wrote Rhea, "nevertheless, that theory, interpreted against past movements of the averages has stood the test of time, while no other device has been so fortunate." No knowledge of Dow's Theory will enable the trader to "beat" the market on movements against the primary trend. Those who have read Hamilton's "Stock Market Barometer" know how often he warned the outsider against playing the secondary or contra-primary movements. This is the floor trader's game. "The professional acts on the shortest notice," wrote Hamilton, "and reactions and rallies give little notice."

No one, however bearish, can claim that the market over the first quarter has gone into a complete collapse. But taking the period since the first danger signals appeared (August, 1959), many stocks and groups have certainly "melted away". Readers who sold their airlines, oils, motors, steels, coppers, etc., for instance, have not fared badly, judging by today's prices. Others can point to some of the electronics, office machine and telephone stocks and argue that they have not been in a bear market. For the benefit of the bulls I might reiterate that all stocks do not go down simultaneously in a bear market, any more than all stocks rise together in a bull market.

Many readers of these Letters lived through 1929 and 1937, and they remember a bear market signal as the "trigger" which precipitated a rapid and violent "crash". As stated in previous Letters, however, no market pattern, whether bull or bear, is an exact duplicate of any other. Note, for example, that the Industrial Average has risen above the 616.45 bear signal point, although the Rails have not. To those who have studied only the bear markets since 1929, this may seem an unusual occurrence, but there are many precedents for such action.

In December, 1899, a bear signal was given. Both Averages broke sharply lower; then Rails (the higher priced Average in those days) rose well above the bear signal point while Industrials barely penetrated their comparable point on the upside. It was not until March of 1900 (four months after the bear signal) that the market really began sliding.

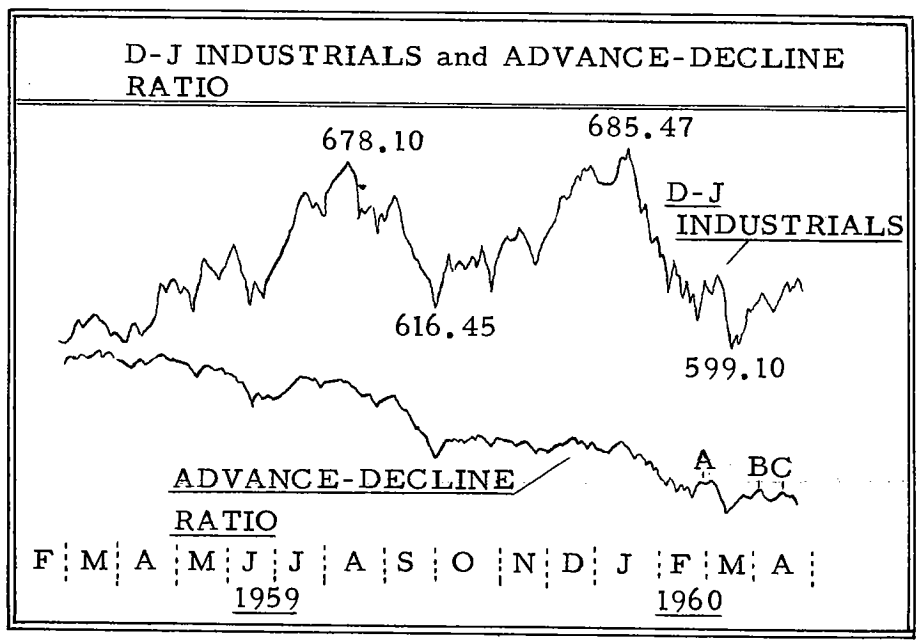
a bear signal was given in April, 1906. After hitting a low in July, both Averages worked back over the bear signal points with Rails (still the higher priced Average) working within a point of the previous bull market highs! A long "line" formed which extended from August to December of 1906. When that line was broken downside by both Averages in December, a disastrous collapse ensued which continued to November of 1907. History describes this movement as "the panic of 1907."

In 1920 (February) a bear signal occurred. Industrials dropped from 110 to 90, then climbed above the bear signal point (103.60) and held in the 105 area all through March and most of April (a line was formed). Everything seemed fine until Industrials broke sharply downside; in the seven months that followed the market lost one-third of its value.

These three cases are unusual, yet they happened. It is well to remember that in this business we are always dealing with probability; there simply are no certainties in the market. While the current bear market is already showing a few "tricks' of its own, probability (if history means anything) does not now favor a bull's making any consistent money on the upside. Many people currently are talking about their holding of Polaroid, Texas Instruments and Litton, but they seldom mention Northwest Airlines, Sinclair or even General Motors and U.S. Steel. By some miracle, none of today's bulls seem to have been caught with any of the widely-held "backbone of the economy" stocks.

BREADTH OF THE MARKET (A-D Ratio)

The advance-decline ratio or "breadth" was discussed last in Letter 93. The breadth is merely the daily ratio of all advances compared to all declines on the N.Y. Stock Exchange. Past history shows that sooner or later the A-D ratio and the Averages must get "in gear" or move together. Persistent divergence between the A-D ratio and the Averages can signal a reversal.



Note (on chart) that the A-D ratio hit its high in March, 1959, and since then has been in a steady downtrend. On the July, 1959 Industrial advance to 678.10, the A-D ratio moved higher but did not better its March peak. Subsequently, the ratio dropped sharply with the D-J Industrials on the August-September, 1959 reaction. When Industrials rose to 685.47 in January, 1960, the A-D ratio merely flattened out, and this again cast doubt on the validity of the Industrial advance. The sell-off of January-March 1960, followed as Industrials and the A-D ratio dropped into new low ground.

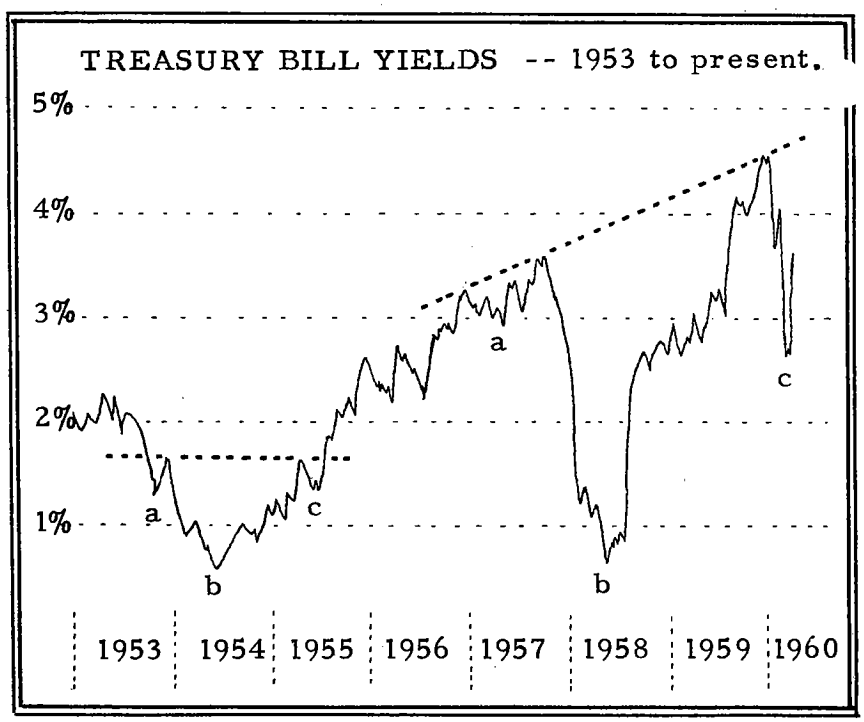
On the recent Industrial advance above 599.10 it was interesting to watch the A-D ratio. A minor peak was made by the A-D ratio towards the end of March (B on chart). A slight decline took place and another minor peak below the B peak was established in early April (C). So far the A-D ratio is continuing to form a series of descending peaks. This means that the Industrial rally since J came without a corresponding improvement in

the breadth of the market, always a signal for caution. (Point A on chart represents the ratio at the peak of the February Industrial rally to 632.00).

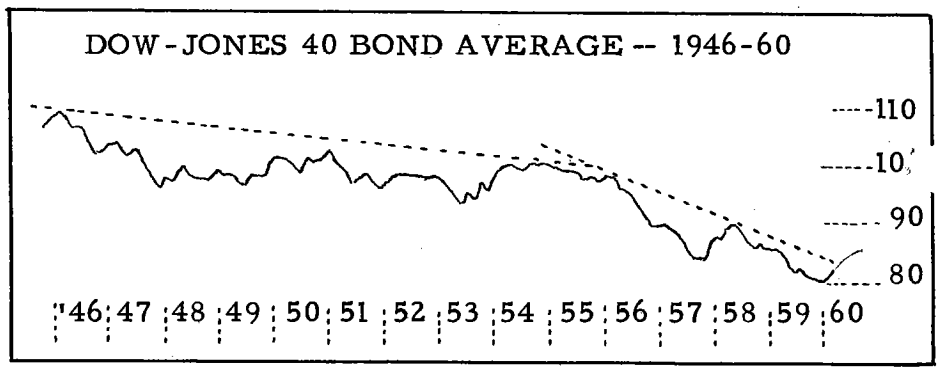
CHARTS AND BILL YIELDS. Theoretically, any commodity which is subject to a free market is also subject to standard chart interpretations. In one sense, these charts are merely devices which measure the forces of supply and demand. Some fields seem to be honeycombed with avid "chart readers", and for some reason others remain practically immune. An example of the latter is the bond field.

I have included a chart of the yields of the most sensitive of all debt instruments, the U.S. Treasury bills (bills, by definition, mature in less than one year). Anyone familiar with standard chart interpretation can pick out the little "inverse head-and-shoulders" pattern which appears inbill yields during 1953-1955. The inverse head-and-shoulder pattern is one of the strongest and most reliable of all reversal patterns, and it consists of a left shoulder (a) on chart, a lower head (b) and a right shoulder (c) which does not fall as low as the head. Following the right shoulder, when the movement betters the neckline (heavy dotted line on chart) it usually carries a good distance further. The power of the move following the 1955 yield breakout is clearly visible, and bill yields advanced from 1.6% in 1954 to 3.5% in 1957.

At present there is a strong suggestion of a tremendous new head-and-shoulder reversal pattern forming in bill yields. The new formation is marked on the chart (the recent dip in 1960 at c forms the right shoulder). Should bill yields now continue higher and break out into the 4.8-5.0% area, the chart suggests a great rise in yields with the probability of a corresponding collapse in the bond market. I suggest that readers watch the short-term Treasury bill yields carefully; a future move above the "neckline" pictured on the chart could be accompanied by economic "fireworks."



In Letter 100 I mentioned the long-term bear market in bonds. This brought many questions from surprised readers, and for this reason I have included a chart of the D-J 40 bonds from 1946 (when the bond bear market began) to the present. It is interesting to observe that the gradually downward sloping trendline of 1946-55 has now given way to a steeper downward trendline. So far, nothing has occurred to suggest that the bear market in bonds has terminated. Mounting Government, State, business and personal debt over the last few years, in fact, has led some observers to conclude that the bond market is in for even rougher sledding ahead.



STOCKS. Puts and shorts should be confined to leading motors and steels. These are about the weakest groups on the board.

(Written Thursday, April 21, 2 P.M.)